Fiduciary Storm Rising

Fiduciary Responsibilities of 401(k) Plan Investment Committees

Storm Clouds on the Horizon

- By some estimates American workers are about $6.5 trillion behind schedule in saving for retirement
- Total annual pre-tax wages of American workers are about $6 trillion
- How likely is it that people will save 100% of their wages in order to catch up?
- What will happen when people realize they don’t have enough money for the retirement they were expecting?

Agenda

- ERISA fiduciaries and their legal responsibilities
- Practical implications for ERISA fiduciaries
  - Relevance to 403(b) plans?
  - Relevance to governmental plans?
    - Michigan statute
    - Best practices
Fiduciary Status
• Functional definition
  • Depends more on your function than your title
  • Variable concept “to the extent that…”

Fiduciary Functions
• You are a fiduciary to the extent that you:
  • Have any discretionary authority or discretionary responsibility in the administration of the plan
  • Exercise any discretionary authority or control over the management of the plan or exercise any authority or control over the management or disposition of plan assets; or
  • Render investment advice for a fee or other compensation or have any authority or responsibility to do so; or

Named Fiduciaries
• Every plan needs at least one named fiduciary – an administrative fiduciary, i.e., a person with responsibility for administration of the plan
• Every plan with assets needs at least one more – an investment fiduciary, i.e., a person with responsibility for investment of plan assets
Examples

- Administration
  - Plan administrator
  - Administrative committee
- Investments
  - Trustee
  - Investment committee
  - Investment manager
  - Investment advisor

Examples

- Attorneys, accountants and actuaries generally are not fiduciaries when acting in their professional capacities
- A third party administrator, record-keeper, or custodian who performs solely ministerial tasks is not a fiduciary

Co-Fiduciaries

- The plan may allocate fiduciary responsibilities among the named fiduciaries
- The plan may allow named fiduciaries to delegate fiduciary responsibilities to other persons
- Special rules for trustees and investment responsibilities
  - Trustees cannot delegate, except to an investment manager
  - The plan may reallocate by providing that the trustee is subject to the direction of a named fiduciary who is not a trustee; then the trustee becomes a “directed” trustee
Business v. Fiduciary Decisions

• Some decisions about the plan are business decisions, not fiduciary decisions
  • Whether to establish or terminate a plan is a business decision
  • The design of the plan is a business decision
  • The operation of the plan, and the investment of plan assets, are fiduciary decisions

Five Basic Fiduciary Duties

• Loyalty – act for the exclusive purpose of providing benefits to participants and beneficiaries and defraying reasonable expenses of administering the plan
• Prudence – act with the care, skill, prudence and diligence that a prudent person acting in a similar capacity and familiar with such matters would use
• Diversification – diversify investments so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do
• Plan documents – follow the terms of the plan unless inconsistent with ERISA
• Trust requirement – hold plan assets in trust

Loyalty

• Requires a fiduciary to discharge his duties solely in the interest of the participants and beneficiaries and for the exclusive purpose of providing participants and beneficiaries with benefits and defraying reasonable expenses of administering the plan
• Supplemented by prohibited transaction rules designed to prevent self-dealing, conflicts of interest, etc.
Prudence

- The prudent expert standard
  - Fiduciaries must be as prudent as the average expert, not the average person
  - If they do not have all of the necessary expertise, they must hire experts who do
- Process v. outcome

Prohibited Transactions

- Related party transactions – transactions with related parties, regardless of whether the transactions are fair and reasonable
- Fiduciary transactions – transactions involving unethical conduct by fiduciaries

Related Party Transactions

- Sale, exchange, or lease of property
- Loan or other extension of credit
- Providing goods, services, or facilities
- Use of plan assets
Fiduciary Transactions

- **Self-dealing** – a fiduciary may not deal with the plan’s assets in his own interest or for his own account.
- **Conflict of interest** – a fiduciary may not act in any transaction involving the plan on behalf of a party (or represent a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries.
- **Kickbacks** – a fiduciary may not receive any consideration for his personal account from any party dealing with the plan in a transaction involving plan assets.

Related Party Transactions

- **Who’s a related party?**
  - Employer
  - Fiduciaries
  - Service providers
  - Various other categories

Service Exemption

- **Exemptions make the world go ‘round**
  - Statutory
  - Regulatory
- **Key exemption** – administrative services are exempt if:
  - Services are provided under a reasonable contract or other arrangement; and
  - Payment is not more than reasonable compensation.
Service Exemption

- Scope of exemption
  - EBSA regulation says the exemption covers the provision of services to the plan, and the payment of fees and expenses from the plan, but not any self-dealing or other prohibited conduct by a fiduciary
  - What does this mean?
    - You can’t use your discretion or authority as a fiduciary to hire yourself or approve your own compensation

Fiduciary Transactions

- IRS and EBSA say you should not act in any transaction in which you have an interest that could affect your best judgment as a fiduciary
  - Example: purchasing an insurance policy for the plan with the understanding that the insurer will provide a lower rate on a policy for the employer
  - Example: receiving a commission or fee on a sale of insurance or investments to the plan
  - If you have a significant conflict of interest, consider retaining an independent fiduciary to review and approve the transaction

Investments

- Trustee
  - Discretionary – trustee picks the investments
  - Directed – other fiduciary or participant picks the investments
- Investment manager – manager picks the investments and directs the trustee
- Investment advisor – advisor provides advice and recommendations; you pick the investments and direct the trustee
Regulatory Environment

- Regulatory jurisdiction
  - ERISA → DOL → EBSA
  - Securities law → SEC

- Regulatory conflict
  - EBSA starts with a fiduciary model
    - ERISA → fiduciary responsibilities
    - Investment Advisers Act of 1940 → investment managers → fiduciary standard
  - SEC starts with a disclosure model
    - Securities Act of 1933 → issuers
    - Securities Exchange Act of 1934 → broker/dealers → suitability

Fiduciary Status of Investment Advisors

- Fiduciary status of investment providers
- Defined benefit (traditional pension) plans
  - Large pools of assets managed by sophisticated, usually institutional, trustees
  - Allow stock brokers and insurance agents to sell product
- Defined contribution (individual account) plans
  - Participants as individual investors
  - Are the disclosure model and suitability standard adequate?

- 1975 ERISA regulation
  1. Advice or recommendations about investments
  2. On a regular basis
  3. Under agreement, arrangement, or understanding
  4. Will be the primary basis for investment decisions
  5. Will be based on particular needs of the plan
  6. Fee or other compensation

- EBSA revising 2 – 5 because investment providers use these to avoid fiduciary status
Fees and Expenses

- If paid by the plan, directly or indirectly, fees and expenses are an important factor, especially in a low-return environment
- Fees and expenses must be
  - Reasonable in light of the administrative services provided
  - Reviewed periodically to determine whether they continue to be reasonable

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Fees and Expenses

- Share classes and expense loads
- Revenue-sharing
  - Do you know how much that mutual fund is paying your investment advisor or plan record-keeper?
  - Plan asset?
  - Prohibited transaction?
- New fee disclosure regulations
  - Disclosure by service provider to plan
  - Disclosure by plan to participants and beneficiaries

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The Litigation Storm

- Lawyer advertising
- Hundreds of class action lawsuits
  - Excessive fees
  - Due diligence – failure to understand revenue-sharing and other compensation arrangements
  - Buying power – failure to negotiate lower fees, lower cost share classes
- $ billions paid in settlements
- Fidelity’s own employees have sued Fidelity over the use of Fidelity funds and high-cost share classes
A Cautionary Tale

- Recent case – Tussey v. ABB, Inc.
- Issues
  - Fund selection
  - Share class
  - Revenue-sharing
- Outcome
  - Fidelity dismissed as defendant; service agreement disclaimed fiduciary status
  - Employer and committee liable for $35.2 million

Another Cautionary Tale

- Even more recent case – Tibble v. Edison International
- Issues
  - Share classes
  - Revenue-sharing
- Outcome
  - Revenue-sharing decided in favor of the employer and fiduciaries, on the facts, but the court left the door wide open for future cases
  - Fund selection decided in favor of the participants because the fiduciaries “reflexively and uncritically” accepted the advisor’s recommendations

It Could Happen To You

- Named defendants
  - Tussey v. ABB, Inc., et al
  - Tibble v. Edison International et al
  - Huizenga v. Genzink Steel Supply & Welding Co., et al, United States District Court for the Western District of Michigan, August 23, 2013
    - Fiduciaries ordered to pay $321,000 to the plan because they breached their fiduciary duties by allowing service providers to receive excessive compensation
- Yale professor’s mail campaign
- EBSA audit interviews
Managing Fiduciary Liability

- In one early case, the court said ERISA fiduciary standards are the highest known to law
- How to manage the risk?
  - Embrace fiduciary responsibility
  - More about process than outcome
  - Careful process; avoid conflicts of interest
  - Exercise fiduciary discretion
  - Courts apply “abuse of discretion” standard of review
  - Fiduciary liability insurance
  - Corporate indemnification and defense

The Practical and Prudent Fiduciary

- Clear delegation of authority and responsibility
  - Board resolutions
  - Committee charter
  - Regular meetings
  - Professional investment advice
    - Acknowledgment of fiduciary status
    - Compensation arrangements that eliminate conflict of interest

The Practical and Prudent Fiduciary

- Keep good records
  - The “keep” part
    - Minutes of meetings
    - Service agreements
    - Audit, administration, and investment reports
    - Plan documents and participant disclosures
  - The “good” part (primarily meeting minutes)
    - Purpose is to document the process
    - Identify everyone present, especially advisors and consultants
    - Summarize issues discussed; identify documents reviewed
    - Summarize actions taken, including reliance on professional advice
    - Identify items for review and discussion at future meetings, such as investments on the “watch list”
The Practical and Prudent Fiduciary

- Be wary of “safe” harbors
- Example: ERISA 404(c) safe harbor
  - EBSA regulations
  - Scope of relief
  - Passive participants
  - Investment education
  - Default investments
  - How safe is this harbor?

The Practical and Prudent Fiduciary

- Hiring service providers
  - Evaluate service needs
  - Identify potential service providers
  - Request and evaluate proposals
  - Review proposed service contract with ERISA attorney
    - Designation vs. disclaimer of fiduciary status
    - Delegation of fiduciary responsibilities
    - Service standards
    - Liability and indemnification
    - License status and disciplinary proceedings

The Practical and Prudent Fiduciary

- Monitoring Service Providers
  - Read reports
  - Review fee and expense disclosures with ERISA attorney or consultant
    - Does disclosure satisfy ERISA requirements?
    - Are the fees and expenses reasonable?
    - Benchmarking
  - Review systems, policies, and practices
  - Check reliability and accuracy of records
  - Follow up on participant complaints
The Practical and Prudent Fiduciary

- Follow the money
  - Find the indirect compensation and other hidden costs
  - Capture it for the plan
  - Decide what to do with it
    - Use for administration expenses?
      - "ERISA accounts"
    - Uneven burden
    - Rebate as investment income?
      - Charge separately for administration expenses
      - Participant account statements
  - Window of opportunity to get out of this mess?

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The Practical and Prudent Fiduciary

- Fiduciary liability insurance
  - Not the same as the ERISA fidelity bond
  - Not the same as director and officer liability insurance
  - Talk to your insurance agent
    - Coverage for defense costs
    - Defense costs go toward deductible
  - Corporate indemnification and defense
    - Articles of incorporation
    - Bylaws
    - Terms of the plan
    - Supplemental agreement

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More Information

Publication – Meeting Your Fiduciary Responsibilities

Available online at
www.dol.gov/ebsa/publications/fiduciaryresponsibility.html